

***United States Court of Appeals
for the Second Circuit***



**BRIEF FOR
APPELLEE**

ORIGINAL
77-5036

To be argued by
THEODORE GEWERTZ

IN THE
**United States Court of Appeals
FOR THE SECOND CIRCUIT**

**Docket No. 77-5036
Bankruptcy No. 76 B 981**

In Re
EASTERN FREIGHT WAYS, INC., *Bankrupt,*

**SIDNEY B. GLUCK, Trustee in Bankruptcy of
EASTERN FREIGHT WAYS, INC.,** *Plaintiff-Appellee.*

against
SEABOARD SURETY COMPANY, *Defendant-Appellant,*

**MANUFACTURERS HANOVER TRUST COMPANY, individually and
as agent for other institutional lenders, INTERNATIONAL HAR-
VESTER CREDIT CORPORATION, FRUEHAUF CORPORATION
and THE CHASE MANHATTAN BANK, NATIONAL ASSOCIA-
TION, and THOMAS J. CAHILL, Trustee in Bankruptcy of
CIATED TRANSPORT, INC.,**

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

**BRIEF OF DEFENDANT-APPELLEE MANUFACTURERS
HANOVER TRUST COMPANY**

WACHTELL, LIPTON, ROSEN & KATZ
*Attorneys for Defendant-Appellee,
Manufacturers Hanover Trust Company*
299 Park Avenue
New York, New York 10017
Tel. (212) 371-9200

**THEODORE GEWERTZ
RONALD M. NEUMANN**
Of Counsel.

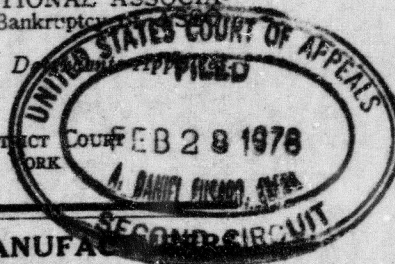
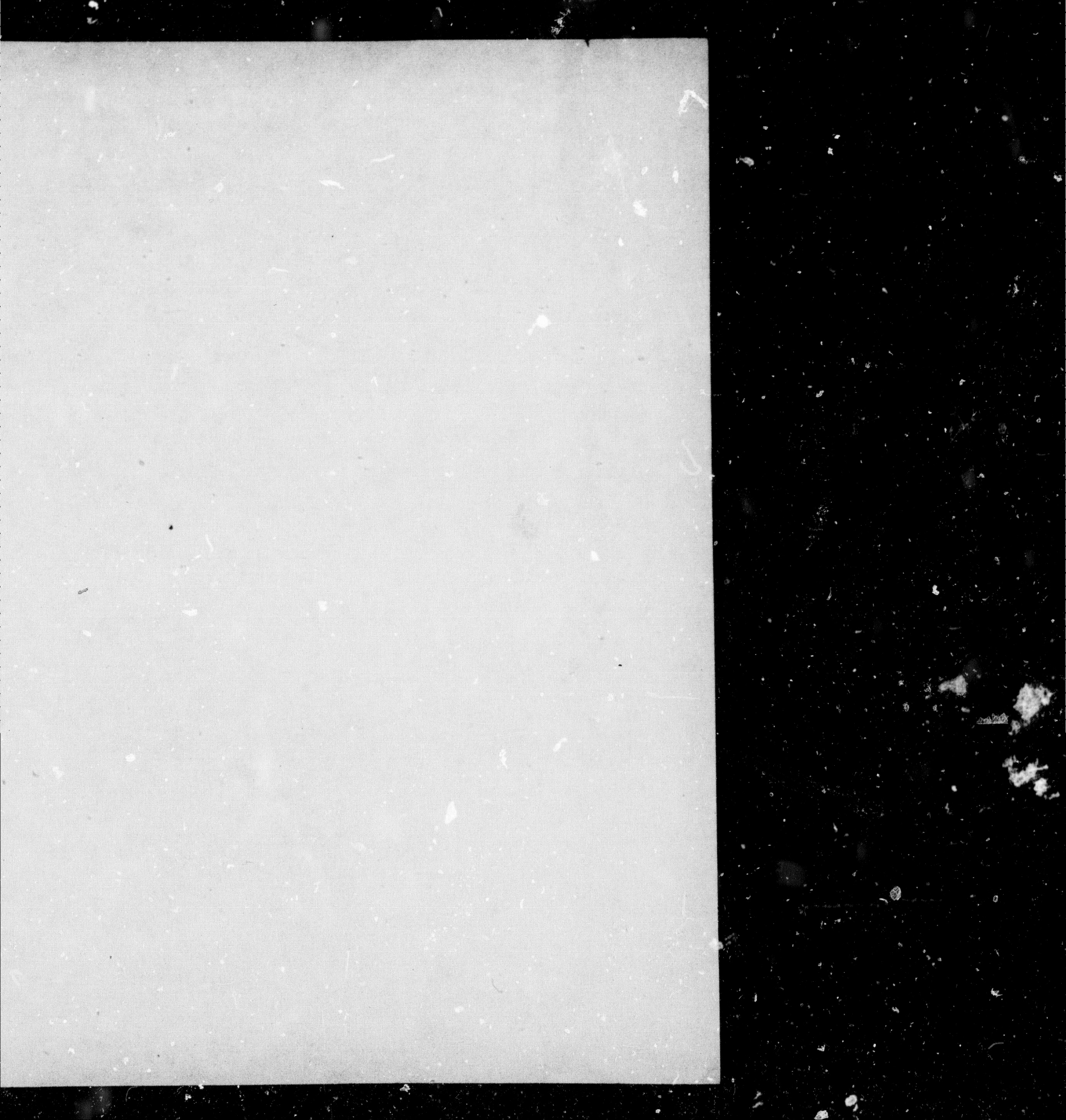


TABLE OF CONTENTS

	PAGE
Statement of Issues Presented	1
Statement of the Case	2
Statement of Facts and Prior Proceedings	4
A. The Pleadings	9
B. Seaboard's Motion	11
C. The Bankruptcy Court Opinion	12
D. The District Court Opinion	14
ARGUMENT:	
POINT I—The District Court correctly affirmed the denial of Seaboard's motion to dismiss the claims and cross-claims seeking declaratory relief denying Seaboard's entitlement to set-off rights and Seaboard's motion for judgment declaring Seaboard's entitlement to such set-off rights	16
A. The <i>Yale Express</i> Case	17
B. Marshaling of Securities	23
C. Release or Waiver of Set-off Rights by Payment of Freight Charges	26
D. Priority of Secured Assignees' Interests Over Surety's Subrogation Rights	27
POINT II—The Bankruptcy Court has summary jurisdiction to determine the scope and applicability of the proceeds of the Chase letter of credit	33
A. Interdependent Issues	35



	PAGE
B. Determination of the Allocation Issue Is Necessary Before the Estate of the Bankrupt Can Be Completely Administered	38
C. Consent to Summary Jurisdiction	40
Express Consent	41
Consent by Filing Proof of Claim As Secured Creditor	46
Consent by Seeking Affirmative Relief	48
Conclusion	50

TABLE OF AUTHORITIES

Cases:

<i>Adickes v. S. H. Kress & Co.</i> , 398 U.S. 144 (1970) ...	17
<i>Aetna Casualty & Surety Co. v. J.F. Brunken & Son, Inc.</i> , 357 F.Supp. 290 (D.S.Dak. 1973)	30, 31, 32
<i>Atlantic Coast Line R. Co. v. United States Fidelity & Guaranty Co.</i> , 52 F.Supp. 177 (M.D. Ga. 1943)	22
<i>Ballou v. General Electric Co.</i> , 393 F.2d 398 (1st Cir. 1968), <i>cert. denied</i> , 401 U.S. 1009 (1971)	16
<i>Becker v. Northway</i> , 44 Minn. 61, 46 N.W. 210 (1890)	22
<i>In re Black Dog Tavern</i> , 2 Bankr. Ct. Dec. 1555 (D. Conn. 1976)	39
<i>In re Blake</i> , 150 Fed. 279 (8th Cir. 1906)	36
<i>Breed v. National Bank of Auburn</i> , 57 App. Div. 468, 68 N.Y. Supp. 68 (4th Dep't 1901), <i>aff'd</i> , 171 N.Y. 648 (1902)	24
<i>Brunswick Corp. v. Clements</i> , 424 F.2d 673 (6th Cir. 1970), <i>cert. denied</i> , 400 U.S. 1010 (1971)	31

TABLE OF CONTENTS

iii

PAGE

<i>Burton Coal Co., In re</i> , 126 F.2d 447 (7th Cir. 1942) ..	39
<i>Chase Manhattan Bank (N.A.), In re</i> , 40 N.Y.2d 590 (1976)	29
<i>Clark Car Co. v. Clark</i> , 48 F.2d 169 (3d Cir. 1931) ...	20
<i>Columbia Bank for Cooperatives v. Lee</i> , 368 F.2d 934 (4th Cir. 1966), <i>cert. denied</i> , 386 U.S. 992 (1967)	24
<i>Conley v. Gibson</i> , 355 U.S. 41 (1957)	16
<i>Cumberland Glass Mfg. Co. v. De Witt</i> , 237 U.S. 447 (1915)	31
<i>Doehler Metal Furniture Co. v. United States</i> , 149 F.2d 130 (2d Cir. 1945)	17
<i>Donson Stores, Inc. v. American Bakeries Co.</i> , 58 F.R.D. 485 (S.D.N.Y. 1973)	16
<i>Dwelle-Kaiser Co. v. Moon</i> , 140 Misc. 475, 250 N.Y. Supp. 714 (Sup. Ct. Erie Co. 1931), <i>modified on other grounds</i> , 235 App. Div. 107, 256 N.Y. Supp. 209 (4th Dep't), <i>aff'd</i> , 260 N.Y. 648 (1932)	24
<i>Engineers Oil Properties Corp., In re</i> , 72 F.Supp. 989 (S.D.N.Y. 1947)	49
<i>Equity Funding Corporation, In re</i> , 396 F.Supp. 1266 (C.D. Cal.), <i>aff'd on other grounds</i> 519 F.2d 1274 (9th Cir. 1975)	39
<i>Fargo v. Squiers</i> , 154 N.Y. 250 (1897)	24
<i>Farmers' Loan & Trust Co. v. Kip</i> , 192 N.Y. 266 (1908)	24
<i>Graham v. Middleby</i> , 213 Mass. 437, 100 N.E. 732 (1913)	32
<i>Heyman v. Commerce & Industry Insurance Co.</i> , 524 F.2d 1317 (2d Cir. 1975)	17

	PAGE
<i>Honeyman v. Hughes</i> , 156 F.2d 27 (9th Cir.), <i>cert. denied</i> , 329 U.S. 739 (1946)	46
<i>Horgan, In re</i> , 158 Fed. 774 (1st Cir. 1907)	38
<i>International Power Securities Corp., In re</i> , 170 F.2d 399 (3rd Cir. 1948)	39
<i>Jackson Brick & Tile Co., In re</i> , 189 Fed. 636 (D. Mo. 1911), <i>rev'd on other grounds</i> , 195 Fed. 188 (8th Cir. 1912)	47
<i>James Talcott, Inc. v. Glavin</i> , 104 F.2d 851 (3d Cir.), <i>cert. denied</i> , 308 U.S. 598 (1939)	36, 37
<i>Jaquith v. Rowley</i> , 188 U.S. 620 (1903)	38
<i>Jonker Corp., In re</i> , 385 F.Supp. 327 (D. Md. 1974) ..	31
<i>Katchen v. Landy</i> , 382 U.S. 323 (1966)	36
<i>Law Research Service, Inc. v. Crook</i> , 524 F.2d 301 (2d Cir. 1975)	36, 39, 47
<i>Ludlum Enterprises, Inc., In re</i> , 13 Collier's Bankr. Cas. 230 (S.D. Fla. 1977)	47
<i>Majestic Radio and Television Corp., In re</i> , 227 F.2d 152 (7th Cir. 1955), <i>cert. denied</i> , 350 U.S. 995 (1956)	36
<i>Meeker v. Halsey</i> , 87 F.2d 299 (2d Cir. 1937)	22
<i>Merts Equipment Co., In re</i> , 438 F.Supp. 295 (M.D. Ga. 1977)	31
<i>Mull v. Colt Co.</i> , 31 F.R.D. 154 (S.D.N.Y. 1962)	16
<i>Murray v. City of Milford</i> , 380 F.2d 468 (2d Cir. 1967)	16
<i>New Park Mining Co. v. Cranmer</i> , 225 F.Supp. 261 (S.D.N.Y. 1963)	16
<i>O'Dell v. United States</i> , 326 F.2d 451 (10th Cir. 1964)	39

TABLE OF CONTENTS

V

PAGE

<i>Operators' Piano Co. v. First Wisconsin Trust Co.</i> , 283 Fed. 904 (7th Cir. 1922)	46
<i>Pepper v. Litton</i> , 308 U.S. 295 (1939)	47
<i>Prokop, In re</i> , 65 F.2d 628 (7th Cir. 1933)	46
<i>Quinn, In re</i> , 165 Fed. 144 (8th Cir. 1908)	47
<i>Sartor v. Arkansas Natural Gas Corp.</i> , 321 U.S. 620 (1944)	17
<i>Second Nat. Bank of Houston v. Phillips</i> , 189 F.2d 115 (5th Cir. 1951)	24
<i>Shannon v. Sutherland</i> , 74 F.2d 530 (4th Cir. 1935)	22
<i>Shelton v. Erwin</i> , 472 F.2d 1118 (8th Cir. 1973)	30
<i>Solar Mfg. Corp., In re</i> , 200 F.2d 327 (3d Cir. 1952), cert. denied, 345 U.S. 940 (1953)	36
<i>Sowell v. Federal Reserve Bank</i> , 268 U.S. 449 (1925)	24
<i>Tidewater Coal Exchange, Inc. v. New Amsterdam Casualty Co.</i> , 20 F.2d 951 (D. Del. 1927)	21
<i>United States v. Bosurgi</i> , 530 F.2d 1105 (2d Cir. 1976)	17
<i>United States v. Diebold, Inc.</i> , 369 U.S. 654 (1962)	17
<i>United States ex rel. Johnson v. Morley Const. Co.</i> , 98 F.2d 781 (2d Cir. 1938)	20, 26
<i>Walker Process Equipment, Inc. v. Food Machinery & Chemical Corp.</i> , 382 U.S. 172 (1965)	16
<i>Yale Express System, Inc., In re</i> , 362 F.2d 111 (2d Cir. 1966)	<i>passim</i>

Statutes and Rules:**Bankruptcy Act:**

Section 68a	29, 31
Section 57h	47
Section 2	47
UCC § 9-104(i)	29
§ 9-318(1)	29
§ 9-204(1)	30
Bankruptcy Rule 306(d)	47
FRCP Rule 56(b)	17

Other Authorities:

2 Collier, <i>Bankruptcy</i> ¶ 23.08 (14th ed. 1976)	41, 49
2A Moore's <i>Federal Practice</i> ¶ 12.08 (2d ed. 1975) ..	16
6 Moore's <i>Federal Practice</i> ¶ 56.04[1] at 56-64, 56-66 (2d ed. 1976)	17

**BRIEF OF DEFENDANT-APPELLEE MANUFACTURERS
HANOVER TRUST COMPANY**

Statement of Issues Presented

1. Whether the District Court erred in affirming the Bankruptcy Court's denial of the bankrupt's surety's motion to dismiss, for failure to state a claim, the claims of the Trustee and the cross-claims of secured assignees of the bankrupt's accounts receivable seeking declaratory relief denying the existence of any rights in the surety to set-off or to compel the set-off against claims against the surety of accounts receivable owing to the bankrupt, until the surety had first exhausted the proceeds of additional collateral in the form of proceeds of a letter of credit securing the obligations of the bankrupt to it where:

(a) the secured assignees of the accounts receivable could look only to the accounts receivable as collateral;

(b) the secured assignees of the accounts receivable had perfected their security interests in the accounts receivable prior to the time any claimed set-off right arose; and

(c) accounts receivable had been paid by the account debtors to the bankrupt without set-off of the claims subsequently asserted against the surety.

2. Whether the District Court erred in affirming the Bankruptcy Court's denial of the surety's motion for summary judgment for a declaratory judgment declaring the existence of such claimed set-off rights and in affirming the Bankruptcy Court's grant of declaratory and injunctive relief to the Trustee that no such set-off rights can be claimed by the surety until the surety first exhausts such letter of credit proceeds.

3. Whether the District Court erred in affirming the Bankruptcy Court's denial of the surety's motion to dismiss, for lack of summary jurisdiction in the Bankruptcy Court, the claims and cross-claims alleging that the surety was entitled to apply the letter of credit proceeds to reimburse itself for the payment of claims asserted against the bankrupt only and not claims asserted against Associated Transport, Inc. ("Associated") and its direction that a hearing be held to determine such issue where:

(a) determination of such allocation issue is necessary in order to enable the Bankruptcy Court to determine whether and when the surety has exhausted the letter of credit proceeds and thereby determine the issue with respect to the surety's set-off rights as to which the Bankruptcy Court concededly had jurisdiction;

(b) determination of such allocation issue is necessary before the estate of the bankrupt can be completely administered; and

(c) the surety both expressly and impliedly consented to the summary jurisdiction of the Bankruptcy Court to determine the allocation issue.

Statement of the Case

This brief is submitted on behalf of Defendant-Appellee Manufacturers Hanover Trust Company ("Manufacturers"), which individually and as an agent for other institutional lenders is an assignee of the accounts receivable of the bankrupt, in opposition to the appeal of Seaboard Surety Company ("Seaboard") from the order of the Honorable Edmund L. Palmieri, dated October 31, 1977 (662a-676a),* affirming the order of the Honorable

* References bearing the suffix "a" are to the pages of the "Joint Appendix" prepared by Seaboard's counsel without con-

(footnote continued on following page)

Roy Babitt, Bankruptcy Judge, entered on May 27, 1977 (543a-549a), which order, in essence:

(a) Denied Seaboard's motion to dismiss, for failure to state a claim, the "First Cause of Action" of the complaint of the Trustee of Eastern Freight Ways, Inc., bankrupt ("Eastern"), against Seaboard in this adversary proceeding and certain cross-claims asserted against Seaboard by Manufacturers and certain other defendants (547a-548a);

(b) Denied Seaboard's motion to dismiss, for alleged lack of summary jurisdiction in the Bankruptcy Court, the "Third Cause of Action" of the Eastern Trustee's complaint and part of the "Third Cross-Claim" of Manufacturers and another defendant (546a, 547a);

(c) Denied Seaboard's motion for summary judgment for a declaratory judgment declaring that it had the right to set off freight charges owing to Eastern against cargo claims filed against Seaboard on bonds issued by Seaboard in favor of shippers using Eastern (547a);

(d) Ordered that the Eastern Trustee is entitled to declaratory relief that no set-off can be claimed by Seaboard until Seaboard exhausts the proceeds of a certain \$2,000,000 letter of credit issued by The Chase Manhattan Bank, National Association ("Chase") for the benefit of Seaboard to secure the payment of Eastern's obligations to Seaboard under a certain indemnity agreement among Seaboard, Eastern and Associated Transportation, Inc. ("Associated") (547a);

(e) Enjoined Seaboard until further order of the Bankruptcy Court from interfering with the adminis-

(footnote continued from preceding page)

sultation with counsel for any of the other parties, which "Joint Appendix" purports to reproduce the entire Record on Appeal, but which in fact includes material stricken from the Record on Appeal. See 675a.

tration by the Eastern Trustee of the Eastern estate and with the assets of that estate, by, among other things, advising the shippers owing freight charges to Eastern to deduct such unpaid freight charges from their cargo claims (548a); and

(f) Directed that a hearing be held as to the scope and allocation of the proceeds of the Chase letter of credit, including the question of whether such proceeds could be applied by Seaboard to reimburse itself for the payment of claims asserted against Associated as well as against Eastern (547a, 548a).

Statement of Facts and Prior Proceedings

According to the pleadings, the undisputed documentary evidence, the prior proceedings before the Bankruptcy Court and the opinions below, the relevant facts for the purposes of this appeal are, in brief summary, as follows.*

Eastern and Associated were each licensed common carriers in the trucking business under the regulatory jurisdiction of the Interstate Commerce Commission ("ICC") (258a, 261a). In accordance with ICC regulations, each of Eastern and Associated was authorized to be a self-insurer for cargo losses sustained by its shipper customers. In 1974, Eastern gained control over Associated, ultimately acquiring a 45% interest (355a, 663a-664a).

On August 26, 1974, Eastern and Associated delivered to Seaboard a "Collateral Agreement" (359a-362a) under which Eastern and Associated agreed to provide collateral for Seaboard's exposure under any surety bonds issued or to be issued on behalf of Eastern or Associated (359a-362a).

* Additional facts not mentioned in this portion of this brief will be referred to where pertinent in the "Argument" portion of this brief.

On September 12, 1974, Eastern procured from Chase for the benefit of Seaboard a letter of credit (269a-270a). According to its terms, Seaboard was authorized to draw up to \$2,000,000 from the letter of credit by sight draft and upon written certification that Seaboard had "not been released from liability under the surety bond(s) or undertaking(s) . . . executed on behalf of *Eastern*" (emphasis supplied) (269a).*

On September 16, 1974, Eastern and Associated, under a "General Agreement of Indemnity," agreed to indemnify and hold Seaboard harmless against any and all liabilities incurred by Seaboard under the bonds issued by Seaboard on behalf of Eastern and Associated (363a-367a).

In or about September, 1974, Seaboard issued bonds on behalf of Eastern in connection with the liability of Eastern as self-insurer to third parties for bodily injury, property damage, workmen's compensation and the like. Seaboard also issued separate surety bonds on behalf of Associated (259a-260a, 533a, 664a).

In August, 1975, Eastern granted to Manufacturers, for itself and as agent for other institutional lenders, security interests in various of its assets, including, among others, its present and future accounts receivable and contract rights. These security interests were given to secure advances which ultimately aggregated the principal amount of \$4,750,000 (312a, 533a-534a). The security interests were duly perfected in accordance with applicable law (313a, 534a). Eastern subsequently granted security interests in certain of its assets, including junior interests in its accounts receivable, to certain other defendants in this adversary proceeding (293a-294a).

On April 22, 1976, Eastern and Associated each filed Chapter XI petitions (1a, 258a, 532a-533a). Shortly there-

* Manufacturers has a 25% (or \$500,000) interest in the Chase letter of credit.

after, on April 28, 1976, each was adjudicated a bankrupt (258a). Seaboard then immediately drew down and received from Chase the entire \$2,000,000 proceeds of the Chase letter of credit (266a, 302a-303a, 324a).

At the time Eastern filed its Chapter XI petition there were outstanding approximately 20,000 unpaid cargo claims which had been presented to Seaboard (261a-262a). Many of these claims were asserted by claimants who also owed freight charges to Eastern. Of these freight charges, only some related to the shipments out of which the cargo claims arose (262a, 316a). After receipt of the proceeds of the Chase letter of credit, Seaboard immediately began sending letters to Eastern's shipper customers advising them that they should deduct from their cargo claims any sums which such customers owed to Eastern for unpaid freight charges. Seaboard also disclaimed all liability except for the difference between the cargo claims and the unpaid freight charges (19a-20a, 264a-265a, 271a).

On September 16, 1976, counsel for the Eastern Trustee, counsel for Manufacturers and others met with representatives of Seaboard, at which time Seaboard declined to refrain from sending additional letters (23a). Thereafter, the Eastern Trustee moved for an injunction prohibiting Seaboard from further interfering with the administration by the Trustee of the Eastern accounts receivable, whether by means of letters or otherwise (7a-39a). The Trustee also sought to have Seaboard held in contempt for violating the automatic stay provisions of the Bankruptcy Rules and orders of the Bankruptcy Court prohibiting any interference with the assets of the bankrupt estate (7a-39a). Manufacturers had prepared and served a similar motion, but it was agreed that all further proceedings would be based on the Trustee's motion (508a-514a).

Seaboard served its answer to the Eastern Trustee's injunction and contempt motion on or about October 7, 1976. The answer included a demand for affirmative relief

seeking a declaratory judgment that Seaboard was entitled to set-off the accounts receivable against its unprocessed cargo claims, under the terms of this Court's decision in *In re Yale Express System, Inc.*, 362 F.2d 111 (2d Cir. 1966) (40a-49a, 59a-61a).

On October 14, 1976, October 21, 1976 and October 26, 1976, hearings were held on the Eastern Trustee's motion (91a-251a), following which Seaboard was temporarily enjoined from further disseminating letters to cargo claimants who were account debtors of Eastern and from interfering generally with the administration of the accounts receivable by the Eastern Trustee (272a-276a).

As is shown clearly by the transcripts of the hearings, the temporary injunction issued by the Bankruptcy Judge was in contemplation of the commencement of an adversary proceeding in the Bankruptcy Court in which the Eastern and Associated Trustees, Seaboard, Manufacturers and other claimants to the Eastern accounts receivable would be parties, and which would be dispositive of all of the rights of all of the parties thereto (111a-112a, 129a, 131a-133a, 137a, 143a-146a, 148a, 154a, 156a, 158a-159a, 163a, 250a-251a).

On or about November 3, 1976, the Eastern Trustee, by agreement among the parties, served the summons and complaint commencing this adversary proceeding (250a-251a, 255a-271a).^{*} All parties except Seaboard and the Associated Trustee filed answers to the complaint on or before December 3, 1976 (277a-344a).^{**} The answer of Manufacturers alleged cross-claims against Seaboard, some of

^{*} The Eastern Trustee's complaint is phrased in terms of contentions made not only by the Eastern Trustee, but by the assignees of the Eastern accounts as well, including Manufacturers, and demands judgment on behalf of plural plaintiffs (262a-263a, 266a-268a).

^{**} The Associated Trustee filed his answer on or about December 10, 1976.

which were similar to the claims asserted in the Eastern Trustee's complaint (311a-333a).

On or about December 3, 1976, Seaboard moved to dismiss the first and second causes of action of the complaint, for failure to state claims upon which relief could be granted and to dismiss the third cause of action for lack of summary jurisdiction of the Bankruptcy Court to determine the claims asserted therein (345a-370a). In that motion, Seaboard, relying again on the *Yale Express* case, again also asked for affirmative relief and a judgment declaring that it had the right to set-off the accounts receivable of Eastern against cargo claims filed with Seaboard on Eastern cargo bonds (346a, 352a).

By separate motion to dismiss dated December 7, 1976, Seaboard moved for dismissal of the cross-claims of Manufacturers for failure to state claims upon which relief could be granted and, with respect to part of one of such cross-claims, for lack of summary jurisdiction of the Bankruptcy Court to determine that claim (371a-372a).

On December 13, 1976, a hearing was held on the Seaboard motions (402a-484a). On April 7, 1977, Judge Babitt rendered his opinion (the "Bankruptcy Opinion") which in essence denied Seaboard's prayers for affirmative declaratory relief as to its set-off rights, made permanent the existing temporary injunction barring Seaboard from sending letters to the Eastern customers and directed that an evidentiary hearing be held as to the proper scope and application of the proceeds of the Chase letter of credit (531a-542a). An order in accordance with the Bankruptcy Opinion was entered on May 27, 1977 (543a-549a). The Bankruptcy Opinion and order were affirmed by Opinion and Order of District Judge Palmieri dated October 31, 1977 (662a-676a).

A. The Pleadings

A summary of the pleadings, Seaboard's motions with respect thereto, Seaboard's prayers for affirmative declaratory relief, the Opinion and the order appealed from, will facilitate the disposition of this appeal.

The Eastern Trustee's complaint pleads three "causes of action".* The first cause of action (259a-263a) alleged that, contrary to Seaboard's contentions that shippers owing freight charges to Eastern (as well as Eastern itself) had a right to set off against such freight charges the amount of any cargo claim owed by such shippers to Eastern and that Seaboard was entitled to such offsets in determining the amount it owed to shippers under its bonds:

(a) neither the shipper, Eastern or Seaboard had the right to such off-sets by reason of the prior assignment of Eastern's accounts receivable, including freight charges, to Manufacturers and others;

(b) any shipper which, having a cargo claim against Eastern, nonetheless paid the freight charges owing by it without asserting or claiming the alleged offset right has waived and released that right, and that accordingly, Seaboard is not entitled to such offset in determining the amount owed to such shipper. This claim is in essence the same as the second cross-claim asserted by Manufacturers against Seaboard; and

(c) if any right of offset of shippers having cargo claims and owing freight charges exists, such right is available only to the extent that such freight charges and cargo claims arose from the same transaction, and Seaboard's offset rights are limited to the same extent.

Manufacturers' first cross-claim (311a-316a) sought a declaratory judgment that Seaboard's interest in the East-

* The second cause of action was dismissed (547a) and is not the subject of any appeal.

ern accounts receivable is solely that of an unsecured creditor, in that, by virtue of paragraph 10 of the indemnity agreement among Seaboard, Eastern and Associated, Seaboard limited its remedies against Eastern with respect to the cargo bond to those of a general creditor and disclaimed any equitable lien against any property of Eastern superior to that of Manufacturers. Manufacturers' first cross-claim also alleges that as between Manufacturers, which gave full present value for its security without notice of any claimed lien in favor of Seaboard, and Seaboard, which has full and adequate security with respect to the Eastern bond, but which seeks to assert rights in the Eastern accounts receivable because it failed to obtain such security with respect to the Associated bond, Manufacturers should prevail.

The May 27, 1977 order of the Bankruptcy Court denied Seaboard's motion to dismiss the Eastern Trustee's first cause of action and Manufacturers' first and second cross-claims (547a-548a). However, the Bankruptcy Court Opinion did not discuss these claims, since in the view of the Bankruptcy Judge, the Eastern Trustee's "third cause of action is dispositive of this case" (537a).

The Eastern Trustee's third cause of action (266a-267a) consists of two claims for declaratory relief:

(a) that notwithstanding any set-off rights which Seaboard might otherwise have, such rights (and the right to direct shippers to set-off unpaid freight charges against cargo claims) did not mature until after Seaboard exhausted the proceeds of the \$2,000,000 Chase letter of credit; and

(b) that Seaboard could use the proceeds of the Chase letter of credit to satisfy only those claims asserted under bonds written for Eastern and not, as claimed by Seaboard, to satisfy as well those claims asserted under bonds written for Associated.

Manufacturers' third cross-claim against Seaboard (323a-331a) is similar in theory to the Eastern Trustee's third cause of action and alleges in further detail that by reason of the fact that Seaboard has available to it two sources of security, to wit, its alleged set-off rights with respect to the freight charges and its access to the proceeds of the Chase letter of credit, while Manufacturers, having liquidated and applied its other collateral, has available to it only one source of collateral for a remaining unpaid debt of \$1,400,000 plus interest, to wit, the freight charges (accounts receivable), Seaboard was obligated under the doctrine of marshaling of securities to resort first to the proceeds of the Chase letter of credit before seeking to apply the freight charges. Manufacturers also claimed damages for Seaboard's wrongful assertion of set-off claims and misapplication of the proceeds of the Chase letter of credit to claims other than those arising from claims under the Eastern bonds (331a).

B. Seaboard's Motion

Seaboard sought to dismiss the Eastern Trustee's third cause of action and Manufacturers' third cross-claim on the ground that such claims related to the proceeds of the letter of credit, which proceeds were in Seaboard's possession, rather than the actual or constructive possession of the Bankruptcy Court, and hence the Bankruptcy Court lacked summary jurisdiction to grant relief with respect to those proceeds (346a, 351a-352a).

In its motion to dismiss the complaint, Seaboard also expressly sought affirmative declaratory relief that certain of Seaboard's contentions, set forth in paragraphs 24, 25 and 26 of the Eastern Trustee's complaint, were correct (346a; see 262a). Specifically, Seaboard, relying almost wholly upon the *Yale Express* case, asked for judgment declaring that:

1. Eastern has a right to and should set off against any cargo claims against Eastern the amount of

freight charges owed by any such claimant to Eastern.

2. A shipper owing freight charges to Eastern has a right to and should set off against such freight charges the amount of any cargo claim owed to such shipper by Eastern.
3. In determining the amount Seaboard owes to a shipper because of Seaboard's obligations under the bonds it has issued to Eastern, Seaboard is entitled to the benefit of such set offs and the balance only shall be paid by Seaboard to such claimant. (352a)

C. The Bankruptcy Court Opinion

Bankruptcy Judge Babitt, in the Bankruptcy Opinion, denied Seaboard's motion to dismiss the Eastern Trustee's third cause of action and Manufacturers' third cross-claim, holding that by seeking affirmative declaratory relief with respect to its alleged set-off rights, Seaboard consented to the summary jurisdiction of the Bankruptcy Court to determine the scope of the Chase letter of credit and Seaboard's right to apply the proceeds to claims other than Eastern cargo claims. This was so, Judge Babitt reasoned, because the issue of Seaboard's right to set-offs was "inextricably intertwined with the existence of the proceeds of the letter of credit" and the application by Seaboard of such proceeds (538a). For this reason and for reasons of judicial economy, Judge Babitt held that he could "properly determine all of the rights of the parties connected with the underlying transaction" (538a).

Turning to the merits of the Eastern Trustee's third cause of action, Manufacturers' third cross-claim, and Seaboard's claim for declaratory judgment with respect to its alleged set-off rights, Judge Babitt held that Seaboard's ability to look to the proceeds of the Chase letter of credit to satisfy its claims for exoneration against Eastern arising from its payment of Eastern cargo claims, dis-

tinguished this case from *Yale Express* and made the rationale of that case inapplicable here (538a-541a). Accordingly, Judge Babitt held that until Seaboard exhausted the Chase letter of credit proceeds, the normal rule—that so long as a principal is solvent and therefore able to respond to a claim by the surety, the surety cannot use the principal's counterclaim to exonerate itself—applied, despite Eastern's insolvency (539a-541a). Thus, the Eastern Trustee was granted a declaratory judgment that until the proceeds of the Chase letter of credit are exhausted, no right of set-off could be claimed by Seaboard (541a). Seaboard's claim to affirmative declaratory relief that it was entitled to such a set-off was, of course, denied, but with leave to Seaboard to return to the Bankruptcy Court to seek leave to assert the alleged set-off rights at such time when it appears that Seaboard is in a no-recourse position (541a).

In view of the holding that Seaboard had no present set-off right, it followed that Seaboard was not entitled to notify Eastern cargo claimants to set-off their freight charges against such cargo claims. Accordingly, the previous temporary restraining order prohibiting such conduct was made permanent, subject to further order of the Bankruptcy Court upon a showing that Seaboard had exhausted its collateral (541a-542a). Judge Babitt also noted that such invitation enabled the account debtors to set-off whatever they wished whether justified or not—a result that was obviously detrimental to the estate and creditors such as Manufacturers whose claims are secured by Eastern's accounts receivable (541a).

Finally, the Bankruptcy Court held that the determination of the dispute as to whether Seaboard could apply the proceeds of the Chase letter of credit to claims other than claims on bonds written for Eastern—resolution of which dispute is essential in order to determine whether Seaboard has properly exhausted such proceeds—should await an evidentiary hearing (542a).

D. The District Court Opinion

In affirming the Bankruptcy Court and in rejecting the arguments which Seaboard continues to press on this appeal, the District Court held:

(a) That the right in the surety of an insolvent principal to invite set-offs recognized in the *Yale Express* case was an equitable exception to the general rule denying such right to the surety of a solvent principal and that the reason for such exception—the enrichment of the estate of the principal at the surety's expense as the result of payment of the insolvent principal by its debtor and the inability of the surety to be fully exonerated or reimbursed from the insolvent estate for payment of the claim of the debtor against the insolvent principal—is not applicable in a situation where, as here, the surety has collateral to apply against its claim for exoneration or reimbursement (666a-668a). Thus, in the District Court's view, the Bankruptcy Court was correct in requiring Seaboard to look to the letter of credit proceeds before attempting to exercise any alleged set-off rights (668a-669a);

(b) That the Bankruptcy Court had summary jurisdiction to determine the "proper use and application of the proceeds of the letter of credit," i.e., whether such proceeds could properly be applied by Seaboard to satisfy claims asserted by Associated shippers as well as Eastern shippers, since such determination was "a necessary prerequisite to the final resolution of the rights of the parties with respect to the set offs, over which the [bankruptcy] court clearly has jurisdiction" (672a-673a). In other words, given the correctness of the holding by the Bankruptcy Court that Seaboard could not properly attempt to assert any set-off rights until the letter of credit proceeds were exhausted, the Bankruptcy Court had jurisdiction to determine whether and when Seaboard had properly

exhausted such proceeds (673a). While rejecting any argument that Seaboard's consent to litigate the set-off issue constituted an implied consent to the Bankruptcy Court's summary jurisdiction to determine the letter of credit allocation issue (671a-672a), the District Court found it unnecessary to, and did not, reach the issue of whether Seaboard had expressly consented to such summary jurisdiction by pre-complaint statements or by filing a proof of claim (671a, 672a); and

(c) That the Bankruptcy Court properly denied Seaboard's motion to dismiss the claims and cross-claims which seek to prevent or restrict Seaboard's alleged set-off rights on grounds independent of Seaboard's possession of letter of credit proceeds (such as the prior assignment of Eastern's accounts receivable and the loss of the set-off right upon payment by the account debtors), since these issues, which "will assume a central importance in the case if and when Seaboard demonstrates that it has exhausted [the] proceeds," "pose substantial issues of fact," as well as "complex points of law" (674a-675a).

As will be demonstrated below, for the reasons set forth above as well as other reasons not dealt with by the District Court, the opinion below was eminently correct.

ARGUMENT

POINT I

The District Court correctly affirmed the denial of Seaboard's motion to dismiss the claims and cross-claims seeking declaratory relief denying Seaboard's entitlement to set-off rights and Seaboard's motion for judgment declaring Seaboard's entitlement to such set-off rights.

The District Court's affirmance of the denial of Seaboard's motion under FRCP Rule 12(b) and its Bankruptcy Rule counterpart (Bankruptcy Rule 712(b)), to dismiss for failure to state a claim upon which relief can be granted, the claims and cross-claims seeking declaratory relief negating Seaboard's claimed set-off rights must be affirmed unless Seaboard can demonstrate that it has satisfied the exacting standard for success on such a motion. That standard is that a motion to dismiss should not be granted "unless it appears to a certainty that plaintiff is entitled to no relief under any state of facts which could be proved in support of the claim." 2A Moore's *Federal Practice* ¶12.08 at 2274 (2d ed. 1975). See *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957); *Ballou v. General Electric Co.*, 393 F.2d 398, 399 (1st Cir. 1968), cert. denied, 401 U.S. 1009 (1971); *Donson Stores, Inc. v. American Bakeries Co.*, 58 F.R.D. 485, 487 (S.D.N.Y. 1973); *New Park Mining Co. v. Cranmer*, 225 F.Supp. 261, 265 (S.D.N.Y. 1963). Moreover, upon such a motion, "the well-pleaded material allegations of the complaint are taken as admitted for the purposes of [the] motion." *Mull v. Colt Co.*, 31 F.R.D. 154, 156 (S.D.N.Y. 1962). See 2A Moore's *Federal Practice* ¶12.08 at 2266-67 (2d ed. 1975); *Walker Process Equipment, Inc. v. Food Machinery & Chemical Corp.*, 382 U.S. 172, 174-75 (1965); *Murray v. City of Milford*, 380 F.2d 468, 470 (2d Cir. 1967) (court must accept as true plaintiff's allegations of fact,

together with such reasonable inferences as may be drawn in plaintiff's favor).

Similarly, in order for Seaboard to succeed on its appeal from the affirmance of the denial of its prayer—contained in its motion to dismiss—for affirmative declaratory relief on its alleged setoff rights, Seaboard must demonstrate that it has satisfied the exacting standards for summary judgment. See FRCP Rules 12(b) and 56(b). It is basic that summary judgment may not be granted unless it appears that there are “no genuine issues of material fact and that the moving party is entitled to judgment as a matter of law.” See 6 Moore’s *Federal Practice* ¶ 56.04[1] at 56-64, 56-66 (2d ed. 1976); *Savior v. Arkansas Natural Gas Corp.*, 321 U.S. 620, 627 (1944). Moreover, it is well-established that “on summary judgment the inferences to be drawn from the underlying facts contained in [the moving party’s] materials must be viewed in the light most favorable to the party opposing the motion.” *Adickes v. S. H. Kress & Co.*, 398 U.S. 144, 158-59 (1970); *United States v. Diebold, Inc.*, 369 U.S. 654, 655 (1962); *United States v. Bosurgi*, 530 F.2d 1105, 1110 (2d Cir. 1976). This Court has repeatedly warned that summary judgment is a drastic remedy which should not be lightly granted. See *United States v. Bosurgi*, *supra*; *Heyman v. Commerce & Industry Insurance Co.*, 524 F.2d 1317, 1320 (2d Cir. 1975); *Doehler Metal Furniture Co. v. United States*, 149 F.2d 130, 135 (2d Cir. 1945).

As can be seen from an examination of the record and as will be shown below, Seaboard has not even begun to approach the showing necessary for the drastic relief it seeks.

A. The Yale Express Case

Both in the courts below and in its brief upon this appeal (pp. 2, 8-25), Seaboard has pointed to the *Yale Express* case as the be all and end all of this litigation. Such reliance is misplaced however, for this case differs

markedly from *Yale Express* with respect to both its facts and the legal principles applicable thereto.

Thus, the pleadings in this case show the existence of at least three fundamental issues not present or dealt with in *Yale Express*:

(a) unlike the surety in *Yale Express*, the surety in this case is collateralized, having available to it up to \$2,000,000 representing the proceeds of the Chase letter of credit, for use in satisfying whatever claims it might have against Eastern to be reimbursed or exonerated for any payments it may be required to make to shippers asserting claims against it under the bonds it wrote for Eastern;

(b) unlike *Yale Express*, this case involves the competing claims of other parties, including Manufacturers, to whom the accounts receivable (freight charges) were assigned as security for money advanced, to the same accounts receivable which the surety seeks to apply in satisfaction of its reimbursement and exoneration rights; and

(c) unlike *Yale Express*, this case involves an issue as to whether the payment of freight charges by a shipper amounts to a waiver or release of the right to set off such charges against cargo claims, thereby precluding the surety from applying the amount of such paid freight charges against its liability to pay the cargo claims.

The courts below found factor (a) above—Seaboard's ability to satisfy its reimbursement and exoneration rights by resort to a source other than a set-off of the accounts receivable—sufficient in itself to distinguish this case from *Yale Express* and warrant denial of Seaboard's motions with respect to its alleged set-off rights. Thus, the Bankruptcy Judge recognized that:

It was clear that in *Yale Express*, the surety had no

recourse against the debtor, and that *its only means of recovery was through a right of set off*. If Seaboard had no recourse against Eastern's trustee [other than filing of a proof of claim] the wise teaching of *Yale Express* would properly apply. But here, to the contrary, Seaboard does have recourse, *i.e.*, the proceeds of the two million dollar letter of credit. To the extent that these proceeds are utilized in the payment of cargo claims, the estate of Eastern's trustee cannot possibly be enriched at Seaboard's expense. In short, Seaboard need not look to these insolvency proceedings to be made whole.

(540a) (emphasis supplied).

The District Court agreed with this conclusion (666a-668a), reasoning that:

It must not be forgotten ~~that~~ we are concerned here with equitable considerations; not with inflexible legal rules. Judge Babitt properly went beyond the "mere insolvency of the principal" to the "underlying rationale for the exception", namely, the impairment of the surety's right of exoneration. *No injustice is done to the surety here by requiring it to seek its exoneration in the collateral apparently established for that very purpose*. Moreover, its rights are protected by the Bankruptcy Judge's grant of leave to return at such time that it appears that Seaboard can make the requisite showing that its collateral is inadequate or has been properly exhausted. In light of these considerations, and given the undeveloped state of the evidence as to both the actual and the proper disposition of the proceeds of the letter of credit by Seaboard, it would be inappropriate for this court to overturn the Bankruptcy Judge's decision.

(668a) (emphasis supplied).

The holdings below are fully consistent with the rationale of *Yale Express*. The starting point, as recognized in

Yale Express, 362 F.2d at 114 and in the opinions below (538a-540a; 667a), is that "when the principal is solvent, a surety cannot compel him to assert a counterclaim in the surety's exoneration, nor can the surety use it himself, when sued." *United States ex rel. Johnson v. Morley Const. Co.*, 98 F.2d 781, 789 (2d Cir. 1938). However, "this ceases to be true as soon as the principal becomes insolvent" since he is no longer "able to respond to the surety's claim over against him for indemnity." *United States ex rel. Johnson v. Morley Const. Co.*, *supra* at 790. See *Yale Express*, *supra*, 362 F.2d at 115; *Clark Car Co. v. Clark*, 48 F.2d 169, 170 (3d Cir. 1931).

This "insolvency exception" to the general rule is what Seaboard seeks to apply to this case, while choosing to ignore the basis for it—the absence of any means other than the set-off by which the surety can be made whole.* To remedy the unsecured surety's plight and to avoid having the insolvent estate of the principal receive the full benefit of payment of the debt (here the freight charges) owed to it by its creditor at the expense of the surety who is required to pay the creditors' claims (here cargo claims) in full, the law recognizes an equitable right in the surety to in effect receive the benefit of the security of the creditor by utilizing the set-off or forcing the creditor to do so. As explained by Judge Learned Hand in the *Morley* case, *supra*, 98 F.2d at 790, quoted with approval in *Yale Express*, *supra*, 362 F.2d at 115:

Thus, the upshot of denying the surety a right to assert the counterclaim is to enhance the principal's

* It is difficult to fathom why Seaboard in its brief (pp. 9-12) goes to such great lengths to attempt to establish that the "insolvency exception" is not an "exception", but a "general rule" applicable where the principal is insolvent. It is submitted that in either case, where the reason for the rule or the exception is not present, the rule or the exception, however labeled, should not apply.

estate at the expense of the surety, which is contrary to the fundamental relation between the two. The truth is that after insolvency the counterclaim becomes the creditor's security for his own claim, a means by which it can be paid dollar for dollar through his right of set-off. However, it is only after the surety pays the creditor that he is subrogated to all the creditor's securities, and that would be a condition here, except that the surety cannot pay the debt without losing the security, for it consists only of the creditor's power to defeat the counterclaim by using his claim to cancel it. Therefore to exact of the surety the normal condition of paying the debt, would be to destroy the security, and it follows that he must be allowed to set it up himself.

Both as a matter of logic and as a matter of precedent, the "insolvency exception" to the normal rule disallowing the surety the benefit of the creditor's set-off rights has no application where the surety has recourse to collateral or other sources which it may apply in full satisfaction of its right to exoneration. In such a case, there is no need for special equitable protection for the surety; the surety will be made whole through application of the collateral; the estate of the bankrupt will not be enhanced at the surety's expense; and no injustice is done to the surety by leaving it to the creditor to determine if and when it will use its set-off rights. It is only where the surety is without another remedy that it will be allowed to use the creditor's set-off. As set forth in *Tidewater Coal Exchange, Inc. v. New Amsterdam Casualty Co.*, 20 F.2d 951, 954 (D. Del. 1927):

the rule is well established that the surety, when sued alone, cannot, in the absence of statutory provision, avail itself of any claims of the principal against the creditor. * * * [Citations omitted.] Exceptions to the rule are, however, sometimes made for the enforce-

ment of certain equities existing in favor of a surety, and which would *otherwise be irremediable*.

(emphasis supplied.)

See also *Meeker v. Halsey*, 87 F.2d 299, 301 (2d Cir. 1937); *Atlantic Coast Line R. Co. v. United States Fidelity & Guaranty Co.*, 52 F.Supp. 177, 188 (M.D. Ga. 1943); *Becker v. Northway*, 44 Minn. 61, 63, 46 N.W. 210 (1890). In *Shannon v. Sutherland*, 74 F.2d 530 (4th Cir. 1935) the availability to the surety of other means of satisfaction was stressed by the court in denying to the surety (an indorser of a note given to an insolvent national bank) the right to set off its own deposit with the bank against its obligation to make good on his indorsement. As set forth therein:

[I]t [the set-off] may be asserted by an indorser, who is not primarily liable on the instrument, if the maker is insolvent and the indorser is the one upon whom the burden of payment will ultimately fall. * * * [Citations omitted.] On the other hand, the indorser who is only secondarily liable *has no right of set-off where he has been indemnified or where the maker is solvent*.

74 F.2d at 531

(emphasis supplied).

Thus, so long as the surety has another source for satisfaction of his exoneration claim, he does not require equitable relief in the form of the use of the set-off right.

Applying the foregoing principles to this case compels the conclusion that Seaboard may not seek to induce the shippers to assert their set-off rights or apply such set-offs in reduction of Seaboard's obligations to those shippers. The amount of outstanding Eastern cargo claims is estimated to be approximately \$740,000 (328a). Seaboard had or should have in its possession the \$2,000,000 proceeds from the Chase letter of credit as security for

Eastern's obligations to exonerate it for payments which it is obligated to make on the Eastern cargo claims. It is able to apply those proceeds in full satisfaction of its claim to exoneration.*

Thus, despite Eastern's insolvency, Seaboard is not without a remedy. Payment of the freight claims will not enhance Eastern's estate at the expense of Seaboard. Unlike the situation in *Yale Express*, equity does not require that the surety, Seaboard, be allowed to resort to the accounts receivable (freight charges) of the insolvent principal (Eastern) to satisfy its exoneration rights and the courts below so held. Indeed, to the contrary, such result would be inequitable to Manufacturers, which as assignee is entitled to have those accounts receivable paid to it and which has no other available collateral. To allow the set-off would also be inequitable to the other creditors who have interests in the accounts receivable junior to those of Manufacturers and to the Eastern Trustee, who is entitled to receive any surplus left after satisfaction of the claims of such creditors.

B. Marshaling of Securities

The decision of the courts below can also be sustained by application of the equitable principle of marshaling of securities. That doctrine has been defined as follows:

The equitable doctrine of marshalling rests upon the principle that a creditor having two funds to satisfy his debt may not, by his application of them to his

* Seaboard persists in stating that its "obligations on its bonds exceed the \$2,000,000 proceeds of the letter of credit" and that "no one has controverted" this contention. See Seaboard Brief, pp. 19, 23, 24. However, such statements necessarily include Seaboard's obligations under its Associated bonds as well as its Eastern bonds and begs the question involved in the allocation issue, to wit, whether Seaboard is entitled to apply the letter of credit proceeds to its Associated obligations.

demand, defeat another creditor, who may resort to only one of the funds.

Sowell v. Federal Reserve Bank, 268 U.S. 449, 456-57 (1925).

See also, e.g., *Farmers' Loan & Trust Co. v. Kip*, 192 N.Y. 266, 282-83 (1908); *Fargo v. Squiers*, 154 N.Y. 250, 262 (1897); *Breed v. National Bank of Auburn*, 57 App. Div. 468, 68 N.Y. Supp. 68, 72-73 (4th Dep't 1901), *aff'd*, 171 N.Y. 648 (1902); *Dwelle-Kaiser Co. v. Moon*, 140 Misc. 475, 250 N.Y. Supp. 714, 721-22 (Sup. Ct. Erie Co. 1931), *modified on other grounds*, 235 App. Div. 107, 256 N.Y. Supp. 209 (4th Dep't), *aff'd*, 260 N.Y. 648 (1932). As set forth in the latter case:

The rule of equity referred to is that, where a creditor has a lien upon two funds for the security of his debt, and another party has an interest in one only of the funds, without any right to resort to the other, equity will compel the creditor to satisfy his debt, if possible, out of the fund in which he alone has an interest.

250 N.Y. Supp. at 722.

The doctrine of marshaling of securities is fully applicable in bankruptcy proceedings. See, e.g., *Columbia Bank for Cooperatives v. Lee*, 368 F.2d 934, 939-940 (4th Cir. 1966), *cert. denied*, 386 U.S. 992 (1967); *Second Nat. Bank of Houston v. Phillips*, 189 F.2d 115, 118 (5th Cir. 1951) ("the referee and the district judge were right in their alternative finding that, under the doctrine of marshaling, the appellant, as the holder of two liens, ought to be required to first resort, for the satisfaction of its debt, to the real estate mortgage before resorting to the assigned accounts or their proceeds").

The instant case presents a classic situation for the application of the marshaling doctrine. Thus, assuming,

arguendo, that Seaboard has the right to set off the accounts receivable (freight charges) against the cargo claims, Seaboard would have two funds or sources of collateral to satisfy its exoneration claims: (1) the proceeds of the \$2,000,000 Chase letter of credit; and (2) the accounts receivable.* On the other hand, Manufacturers, having already fully exhausted its other collateral, is left with an outstanding principal debt due it of \$1,400,000 plus interest and only one fund as collateral therefor—the accounts receivable.

Application of the doctrine of marshaling would compel Seaboard to satisfy its exoneration claim out of the fund "in which [it] alone has an interest"—the \$2,000,000 Chase letter of credit proceeds—while allowing Manufacturers to look to the accounts receivable undiminished by application to Seaboard's claim. Since the best estimate presently available is that the cargo claims against Eastern aggregate at most approximately \$740,000, there can be little doubt that Seaboard's exoneration claims arising from its payments under the Eastern bonds will be fully paid.

In sum, when viewed in the context of the marshaling of securities doctrine, the conclusion of the Bankruptcy Court (541a) that its

view of the limitations inherent in the *Yale Express* case is compatible with the rights of those litigants here who claim to be secured by the very receivables due to the bankrupt's trustee which Seaboard's action would place beyond the trustee's reach,

is particularly appropriate and correct.

* In *Yale Express*, Judge Friendly observed that the set-off right "has all of the characteristics of an equitable lien." 362 F.2d at 115.

**C. Release or Waiver of Set-off Rights
by Payment of Freight Charges**

Among the claims which the Bankruptcy Court refused to dismiss was Manufacturers' second cross-claim and that part of the Eastern Trustee's first cause of action which allege that in determining the amounts owed on cargo claims to shippers who paid freight charges, Eastern is not entitled to set off the amounts paid by shippers, since the shippers' set-off right, if any, is waived or released upon such payment (262a, 320a). Nowhere in Seaboard's Brief does Seaboard attempt to demonstrate that these allegations are erroneous. *Cf.* Seaboard Brief, p. 24. This is not surprising, since the analysis of the nature of the set-off right in *Yale Express* and the cases relied upon therein would appear to sustain such claims.

Thus, in *Yale Express*, Judge Friendly recognized that the indebtedness for freight owed by the shippers was security for the payment of their cargo claims, but security which could only be applied by its use for set-off purposes:

What Boston is in fact asserting is that as a surety it is equitably entitled to require the trustee to require the shippers to apply their security, to wit their indebtedness for freight, for Boston's benefit in *the only way in which this particular form of security can be applied, by reducing the claims against both principal and surety.*

362 F.2d at 115
(emphasis supplied).

The conclusion that payment of the freight claim by the shippers destroys its potential use for set-off purposes was even more explicitly stated by Judge Learned Hand in the *Morley* case:

However, it is only after the surety pays the creditor that he is subrogated to all the creditor's securities, and that would be a condition here, except that the

surety cannot pay the debt without losing the security, *for it consists only of the creditor's power to defeat the counterclaim by using his claim to cancel it.* Therefore to exact of the surety the normal condition of paying the debt, would be to destroy the security, and it follows that he must be allowed to set it up himself.

98 F.2d at 790
(emphasis supplied).

As can be seen from the foregoing quotations, the very reason for allowing the surety the creditor's set-off rights in an insolvency situation is that such rights cease to exist once the creditor pays what it owes to the insolvent principal. As applied here, the unpaid freight charges may not be used to reduce cargo claims once such freight charges are paid. By definition, the act of payment carries with it the elimination of such charges as the basis for a set-off. Thus, the Bankruptcy Court was indisputably correct in denying Seaboard's motion to dismiss Manufacturers' second cross-claim and its counterpart in the Eastern Trustee's first cause of action and the District Court properly affirmed such denial.*

D. Priority of Secured Assignees' Interests Over Surety's Subrogation Rights.

As noted above, one of the many critical areas in which this case differs from *Yale Express* is the presence here of secured assignees of the accounts receivable (freight

* Contrary to Seaboard's contention at pp. 23-25 of its Brief, there is no injustice in enjoining Seaboard from attempting to compel shippers to assert set-offs until Seaboard has properly exhausted the letter of credit proceeds. As the District Court properly observed (668a), "its rights are protected by the Bankruptcy Judge's grant of leave to return at such time that it appears that Seaboard can make the requisite showing that its collateral is inadequate or has properly been exhausted." See 541a. Seaboard has been free to make such a motion at any time, but has failed to do so. Moreover, Seaboard has sought neither expedited appeals from the orders below nor stays of such orders pending appeal.

charges) in issue. Thus, regardless of whether Seaboard is ultimately held to have a set-off right *vis-a-vis* the Eastern Trustee, the question of the competing claims of Seaboard and the secured assignees of the accounts receivable remains to be resolved.

The issue with respect to such competing claims has been raised by the pleadings: (a) in the Eastern Trustee's first cause of action which seeks, *inter alia*, a declaratory judgment that by reason of the prior assignment of Eastern's accounts receivable, neither the shipper, Eastern or Seaboard had the right to set off the freight charges against cargo claims (262a), and (b) Manufacturers' first cross-claim for a declaratory judgment that Seaboard's interest in the Eastern accounts receivable is solely that of an unsecured creditor, in that, by virtue of paragraph 10 of the indemnity agreement among Seaboard, Eastern and Associated, Seaboard limited its remedies against Eastern with respect to the cargo bond to those of a general creditor and disclaimed any equitable lien against any property of Eastern superior to that of Manufacturers. Manufacturers' first cross-claim also alleges that as between Manufacturers, which gave full present value for its security without notice of any claimed lien in favor of Seaboard, and Seaboard, which has full and adequate security with respect to the Eastern bond, but which seeks to assert rights in the Eastern accounts receivable because it failed to obtain such security with respect to the Associated bond, Manufacturers should prevail (312a-316a).

The Bankruptcy Court denied Seaboard's motion to dismiss these claims, but did not discuss them, since it held that no set-off right in Seaboard had accrued (537a). The District Court however ruled that the denial was proper since the "exacting standard" which Seaboard was required to meet upon such a motion had not been satisfied (674a-675a). Seaboard's Brief on this appeal does not deal with these claims, except in a brief and cursory

fashion (see Seaboard Brief, pp. 25-27). In essence, Seaboard seeks to keep this case within the confines of *Yale Express* by pointing to UCC § 9-104(i), which states that Article 9 of the UCC, dealing with secured transactions, does not apply to any right of set-off. At the same time however, Seaboard, somewhat inconsistently, points to as "controlling on this question" (Seaboard Brief, p. 26) *In re Chase Manhattan Bank (N.A.)*, 40 N.Y.2d 590 (1976), a case determining rights under Article 9 of the UCC and holding that under UCC § 9-318(1) an account debtor may set off against the assignee an independent claim against the assignor arising subsequent to the assignment if the claim arose before the assignee received actual notice of the assignment.*

Seaboard's argument ignores numerous questions of fact and law raised by Manufacturers' and the Eastern Trustee's claims, the existence of which issues is more than sufficient to compel denial of Seaboard's motion to dismiss. Thus, even were UCC § 9-318(1) to be applicable here, numerous issues of fact arise thereunder. For example: (a) did the account debtor receive actual notice of the assignment;** (b) did the set-off claims arise from the same contract which resulted in the account sued upon or a different contract; (c) if a different contract and actual notice was given, when did the claim arise and when did the account debtor receive actual notice of the assignment?

More fundamentally however, Seaboard's argument fails to address the questions of whether, given the account debtor's set-off right, the surety is entitled to the set-off

* The *Chase Manhattan* case was not a bankruptcy case and did not involve the issue present in this case as to whether any set-offs could be allowed under Section 68a of the Bankruptcy Act. See p. 31, *infra*.

** The statement in Seaboard's Brief (p. 27) that "no actual notice was given to any shipper" is without evidentiary support and indeed, will be proven false upon trial.

where the account has previously been assigned for present value and whether such claimed set-off right will be given priority over the security interest of the assignee. Manufacturers submits that the answer to each of these questions is "no." Though research has thus far failed to disclose any bankruptcy cases involving a priority conflict between an attempted set-off by a surety of accounts owing to the bankrupt principal and a pre-petition assignee with a perfected security interest in the accounts, application of pertinent statutory law and an analysis of the interests of the parties indicates that the assignee is entitled to priority over the surety.

Thus, in the present case, since there is a pre-existing security agreement and Manufacturers has previously given value, Manufacturers' security interest attached to the accounts receivable as soon as Eastern performed its contracts and thereby acquired rights in the receivables. UCC § 9-204(1). On the other hand, Seaboard's alleged set-off right with respect to the accounts, if it arose at all, did not arise until Eastern became insolvent. See, *e.g.*, *Yale Express, supra*, 362 F.2d at 114. Accordingly, Manufacturers' rights as assignee of the accounts are prior and superior to Seaboard's set-off rights therein. See *Aetna Casualty & Surety Co. v. J.F. Brunken & Son, Inc.*, 357 F.Supp. 290, 293 (D. S.Dak. 1973) ("[A]s a general rule a surety cannot retain security as against prior attaching creditors.")

Nor can Seaboard rely upon an "equitable lien" theory (see *Yale Express, supra*, 362 F.2d at 115) to gain priority over Manufacturers. At least in the context of institutionalized commercial transactions such as the present, since the advent of the UCC the doctrine of equitable liens, whatever its continued vitality might be as between the original parties to a transaction, cannot be used to defeat the rights of secured creditors, with prior perfected security interests. See, *e.g.*, *Shelton v. Erwin*, 472 F.2d 1118,

1120 (8th Cir. 1973); *Aetna Casualty & Surety Co. v. J.F. Brunken & Son, Inc.*, 357 F.Supp. 290, 293-94 (D. S.Dak. 1973). The creation of an equitable lien in favor of Seaboard to the detriment of Manufacturers cannot be justified. As held in the *Aetna Casualty* case, *supra*, in language applicable as well here:

An equitable lien is recognized as an equitable remedy and the doctrines and maxims which form the foundation of equity jurisprudence are applicable. * * * Thus the consideration of unjust enrichment and unconscionable retention of property come to bear. Upon the facts now before this court I find that Aetna is not entitled to an equitable lien upon the proceeds from the sale of the Brunken personal property. The defendant banks have not been unjustly enriched by acting upon their security interests and foreclosing upon the secured construction equipment.

357 F.Supp. at 294.

See also *In re Merts Equipment Co.*, 438 F.Supp. 295, 298 (M.D. Ga. 1977).

By its motions Seaboard appears to be claiming that as a matter of law it is entitled to the set-off under Section 68a of the Bankruptcy Act. Contrary to Seaboard's claim, the law is clear that a set-off under § 68a is "permissive rather than mandatory" and is a matter as to which the Bankruptcy Court "exercises its discretion * * * upon the general principles of equity." *Cumberland Glass Mfg. Co. v. De Witt*, 237 U.S. 447, 455 (1915). See also, *e.g.*, *Brunswick Corp. v. Clements*, 424 F.2d 673, 675 (6th Cir. 1970), *cert. denied*, 400 U.S. 1010 (1971); *In re Jonker Corp.*, 385 F.Supp. 327, 330 (D. Md. 1974). In the present case, it would appear that as between Seaboard and Manufacturers, there is no reason why equity should intervene to deny Manufacturers—which advanced full value for the accounts and which finds itself with a \$1,400,000 shortfall

—the benefit of part of its only remaining collateral by allowing Seaboard, whose claims against Eastern are otherwise secured (by the Chase letter of credit), to apply that collateral to satisfy its claims against Eastern. As far back as *Graham v. Middleby*, 213 Mass. 437, 443-44, 100 N.E. 732 (1913) the courts have recognized that:

The [set-off] doctrine contended for is one of equity merely, and will be applied only so far as is necessary for the proper protection of a surety and *only so far as can be done without injury to the rights of others having equal or superior equities to those invoked in the special case.*

(Emphasis supplied.)

See also *Aetna Casualty & Surety Co. v. J.F. Brunken & Son, Inc.*, 357 F.Supp. 290, 293-94 (D. S.Dak. 1973).

In any event, as the foregoing authorities indicate, the issue is one which must be decided by the Bankruptcy Court after an evidentiary hearing at which all facts relevant to its equitable discretion to allow or disallow the set-off may be heard. These facts include, among other things, an analysis of the agreements between the various parties, consideration of Seaboard's conduct in dealing with the account debtors and Seaboard's possible misapplication of the proceeds of the Chase letter of credit. (See, e.g., 387a, 389a-391a, 487a-488a, 512a-514a). For example, the Bankruptcy Court's Opinion (541a) alluded to Seaboard's inequitable conduct in giving the account debtors "the exclusive right to set off whatever they wish whether justified or not, a tender treatment not usually accorded by diligent trustees."*

* * * * *

* In this connection it should be noted that the letter sent to the account debtors by Seaboard in this case did not, as claimed by Seaboard, merely "notify such shipper of the rights given

(footnote continued on following page)

In sum, by reason alone of the existence of questions of fact relating to Seaboard's claimed equitable entitlement to a set-off right—quite apart from Seaboard's erroneous view of the law—Seaboard's motions to dismiss for failure to state a claim and for summary judgment on its own declaratory judgment claims were properly denied. Moreover, other questions of fact and law remain to be resolved in this adversary proceeding. Thus, for example, issues exist as to: (a) the scope of Eastern's contractual liability to Seaboard under the agreements between them; (b) the whole issue as to whether the Chase letter of credit proceeds may be applied in satisfaction of Seaboard's claims for exoneration arising out of its payment of Associated cargo claims (see 542a, 673a); and (c) the issue of conflicting priorities between Seaboard and Manufacturers and the other account assignees.

The existence of the foregoing issues, among others, compelled the Bankruptcy Court to deny Seaboard's dismissal and summary judgment motions, compelled the District Court to affirm such denial and should compel this Court to affirm the District Court.

POINT II

The Bankruptcy Court has summary jurisdiction to determine the scope and applicability of the proceeds of the Chase letter of credit.

The essential issue involved in the Eastern Trustee's third cause of action and Manufacturers' third cross-claim is the proper scope and allocation of the Chase letter of

(footnote continued from preceding page)

him by Section 68a". See Seaboard Brief, p. 23. Rather, the letter sent here went materially beyond the *Yale Express* model of an informative letter and instead advised the shippers that they should take the set-off and that "[i]n no event are we responsible for more than the difference [between the freight charges and the cargo claim] * * *." (271a, 377a-378a, 381a).

credit; i.e., whether the proceeds of the letter of credit should be applied solely to cargo claims arising from Eastern's operations or to claims arising from the operations of both Eastern and Associated (542a, 670a). The Eastern Trustee, Manufacturers and the other assignees of the accounts receivable and Chase, the issuer of the letter of credit,* claim that the letter of credit by its terms is available to Seaboard as collateral for its right to reimbursement for its payment of claims against Eastern only. (266a, 326a-327a, 485a-489a; Seaboard Brief, p. 21 fn). On the other hand, Seaboard and the Associated Trustee contend that the terms of the letter of credit should be reformed so as to give effect to what they claim was the intention of the parties to have the letter of credit cover both Eastern and Associated claims (356a-357a; Seaboard Brief, p. 19).

Seaboard contends however that the letter of credit proceeds are property in Seaboard's possession as to which Seaboard has an adverse claim, and accordingly, the actual or constructive possession of the Bankruptcy Court necessary to vest summary jurisdiction in the Bankruptcy Court to determine the dispute with respect to the proper allocation of the letter of credit proceeds is lacking. See Seaboard Brief, pp. 2, 29-43.

The courts below rejected Seaboard's jurisdictional objection, the District Court holding that a determination of the allocation issue by the Bankruptcy Court is "a necessary prerequisite to the final resolution of the rights of the parties with respect to the setoffs, over which the court clearly has jurisdiction" (673a), and the Bankruptcy Court holding that the allocation issue and the issue of Seaboard's set-off rights were "inextricably intertwined" (538a). In other words, given the premise that Seaboard's set-off rights do not accrue until it has properly exhausted

* As noted above, Manufacturers has a 25% interest in the Chase letter of credit.

the letter of credit proceeds, the Bankruptcy Court had the power to determine whether and when the proceeds had properly been exhausted. As explained by the District Court (673a):

What Seaboard has actually spent is thus not the question; the question is what Seaboard was entitled to have spent, given a proper interpretation of the contractual terms and associated instruments, and whether such authorized expenditures have exhausted the proceeds. This latter question, upon the resolution of which depend the rights of the parties as to the set-offs, requires an examination and interpretation of the parties' rights in and to these proceeds, and in particular, a determination of whether such proceeds must be used solely to satisfy claims under bonds written by Seaboard for Eastern, as alleged in the complaint.

The affirmance of the Bankruptcy Court's denial of Seaboard's jurisdictional motion can be sustained not only upon the ground set forth by the courts below, but upon numerous other grounds as well. Thus, as will be demonstrated below, it is erroneous for Seaboard to state that if the determination of the set-off issue is resolved by this Court in Seaboard's favor, "no jurisdictional ground remains for any adjudication by the bankruptcy court of whether or not the proceeds were properly exhausted, and there will be no need for this Court to turn to the jurisdictional question presented here." See Seaboard Brief, p. 29.

A. Interdependent Issues

The law is clear that where the determination of a claim or issue as to which the bankruptcy court clearly has summary jurisdiction is dependent upon the resolution of an issue or claim as to which the bankruptcy court would not have summary jurisdiction if brought independently, the bankruptcy court nonetheless has summary jurisdiction to

determine the latter issue or claim. See, e.g., *James Talcott, Inc. v. Glavin*, 104 F.2d 851, 853 (3d Cir.), *cert. denied*, 308 U.S. 598 (1939); *In re Solar Mfg. Corp.*, 200 F.2d 327, 330-31 (3d Cir. 1952), *cert. denied*, 345 U.S. 940 (1953); *In re Majestic Radio and Television Corp.*, 227 F.2d 152, 156 (7th Cir. 1955), *cert. denied*, 350 U.S. 995 (1956) (dictum); *In re Blake*, 150 Fed. 279, 283 (8th Cir. 1906). Cf. *Katchen v. Landy*, 382 U.S. 323, 333-34 (1966); *Law Research Service, Inc. v. Crook*, 524 F.2d 301, 313-15 (2d Cir. 1975). Thus, in *James Talcott, Inc. v. Glavin*, *supra*, the assignee of accounts receivable sought in the bankruptcy court to recover from the estate the proceeds of those assigned accounts which had been paid to the bankrupt prior to bankruptcy and the trustee asserted counterclaims challenging the validity of the assignments and seeking, *inter alia*, the surrender of all uncollected accounts in the assignee's possession. The Third Circuit affirmed the lower courts' denial of the assignee's motion to dismiss the counterclaims for lack of summary jurisdiction, even though it recognized that no such jurisdiction would exist were the issue of the validity of the assignment not already before the court as the result of the assignee's claim and the trustee's answer denying the validity of the assignments. 104 F.2d at 853. As set forth therein:

[T]he matters here raised in the counterclaims are closely connected with the "subject-matter of such claim or petition". The appellant's claim to the property delivered to the bankrupt estate in full or part payment of certain accounts receivable depends upon the validity of the assignments of these accounts. Similarly, the appellee's counterclaims to the property delivered to the appellant in full or part payment of these same accounts depend upon the invalidity of the identical assignments upon which the appellant's claim

is based. It is difficult to imagine more interrelated and closely connected conflicting claims.

104 F.2d at 853.*

In the present case it can readily be seen that under the rationale of the determination below of the merits of the set-off issue, the issue of Seaboard's set-off rights and the issue as to allocation of the letter of credit proceeds are interdependent. Thus, Seaboard is not entitled to seek an equitable right of set-off until it first exhausts the letter of credit proceeds. There can be no determination as to when Seaboard might be eligible to claim a set-off until it is determined that such proceeds have in fact been exhausted and Seaboard is left without collateral for its right to be exonerated by Eastern. But the issue as to whether the letter of credit proceeds have been exhausted cannot be determined without first determining the scope and applicability of the letter of credit. Thus, if it is held that the proceeds should properly be applied only to Eastern cargo claims, then, by reason of the fact that such claims are estimated to be at most \$740,000, the \$2,000,000 proceeds of the letter of credit are not likely to be exhausted and Seaboard's claimed set-off right will not accrue. On the other hand, if it is held that Seaboard may properly apply the letter of credit proceeds to Associated cargo claims and to other liabilities as well as to Eastern cargo claims, it is likely that the proceeds will have been properly exhausted and Seaboard would then have eliminated an obstacle to its claim to a set-off right.

It cannot seriously be disputed that, as the Bankruptcy Court concluded, the set-off issue and the letter of credit

* Thus, it is not necessary that the two issues involve a "single transaction" as Seaboard contends (Seaboard Brief, p. 38 fn). Rather, it is sufficient that the two issues be "closely connected" or "depend[ant] upon" the other. *James Talcott, Inc. v. Glavin*, *supra*, 104 F.2d at 853.

proceeds allocation issue are "inextricably intertwined", or that as concluded by the District Court, determination of the allocation issue is a "necessary prerequisite" to the ultimate determination of the set-off issue. Indeed, under the rationale of the decisions below on the merits of the set-off issue, the ultimate determination of that issue—as to which the Bankruptcy Court concededly has summary jurisdiction—is dependent upon the determination of the allocation issue. Under such circumstances, the Bankruptcy Court has summary jurisdiction to determine the allocation issue, and the jurisdictional holdings below were correct.*

**B. Determination of the Allocation Issue Is
Necessary Before the Estate of the Bankrupt
Can Be Completely Administered**

None of the parties disputes the Bankruptcy Court's summary jurisdiction to determine questions relating to the accounts receivable of the Eastern estate—property which concededly is within the constructive possession of the Bankruptcy Court. It is readily apparent that the amount of such receivables which will come into the estate (after payment of secured creditors) and thus the amount of assets available for general creditors will be directly affected by determination of the allocation issue. Under the holding of the courts below, these receivables will not be depleted by the Seaboard set-offs, if the letter of credit proceeds ultimately are held to be applicable only to Eastern cargo claims. Thus, the allocation issue must first be determined before the estate of Eastern can be fully and completely administered.

* The cases of *Jaquith v. Rowley*, 188 U.S. 620 (1903) and *In re Horgan*, 158 Fed. 774 (1st Cir. 1907), extensively relied upon by Seaboard in its brief (pp. 32-33), although involving collateral given by bankrupts held by sureties, merely state the unexceptionable principle that an adverse claimant in possession against whom a turnover order is sought may not be compelled to litigate his right to retain the property in a summary proceeding in the bankruptcy court.

The law is clear that where the estate of the bankrupt cannot be completely administered without determining a controversy over which the Bankruptcy Court would not otherwise have summary jurisdiction, such jurisdiction will lie. See, e.g., *In re International Power Securities Corp.*, 170 F.2d 399, 402-03 (3rd Cir. 1948); *In re Burton Coal Co.*, 126 F.2d 447, 448-49 (7th Cir. 1942); *O'Dell v. United States*, 326 F.2d 451, 455-56 (10th Cir. 1964); *In re Equity Funding Corporation*, 396 F. Supp. 1266, 1271-1274 (C.D. Cal.), *aff'd* on other grounds, 519 F.2d 1274 (9th Cir. 1975); *In re Black Dog Tavern*, 2 Bankr. Ct. Dec. 1555, 1559-60 (D. Conn. 1976).^{*} Thus, in the *O'Dell* case, *supra*, the Tenth Circuit, in rejecting the jurisdictional objection, stated the limits upon jurisdiction upon which Seaboard here relies, but went on to observe:

However, these rules are subject to certain well recognized exceptions. A court of bankruptcy does have jurisdiction and power to determine a controversy between third parties concerning the ownership of property in which neither the bankrupt nor the trustee has title if it is impossible to administer completely the estate of the bankrupt without determining that controversy. *Reconstruction Finance Corp. v. River-view State Bank*, *supra*; *Central States Corp. v. Luther*, *supra*, 215 F.2d at 45, and cases therein cited.

^{*} Contrary to Seaboard's assertion at pp. 38-39 of its Brief, it is difficult to discern how this line of cases was confined by this Court in *Law Research Service, Inc. v. Crook*, 524 F.2d 301 at 314 (2d Cir. 1975) to reorganization and arrangement cases, since that case was itself an arrangement case. If anything, that case stands for a liberal judicial attitude with respect to the jurisdiction of the bankruptcy court to determine issues which would not otherwise be within their summary jurisdiction but for the fact that such issues were closely connected with issues as to which the bankruptcy court had summary jurisdiction and which were essential to the administration of the estate. See 524 F.2d at 313, 314. ("In other instances bankruptcy court jurisdiction has been expanded to meet the exigencies of particular fact situations.")

And, the right to a plenary suit is a procedural right which may, of course, be waived. * * *

* * *

It is true that the controversy over the funds is between third parties, i.e., appellant and the I.R.S., and concerns the ownership of property in which neither the bankrupt nor the trustee has title. *But that controversy does relate to the amount and satisfaction of tax liabilities of the bankrupt and appellant and therefore is so intertwined with the tax litigation in the bankruptcy case that the estate of the bankrupt cannot be completely administered without determining the dispute.* Clearly, the decision as to whether the funds should be paid to the I.R.S. will have a substantial effect upon the tax claim in the bankruptcy case.

326 F.2d at 455-56
(emphasis supplied).

In the present case, determination of the allocation dispute will to a large extent be determinative of the set-off issue and all its ramifications and thus is essential to the complete administration of the Eastern estate. Retention by the Bankruptcy Court of jurisdiction to determine the allocation issue may be sustained on this ground in addition to the ground stated by the courts below.*

C. Consent to Summary Jurisdiction

Summary jurisdiction in the Bankruptcy Court over the allocation issue may also be sustained on the basis of

* Seaboard's suggestion that the allocation issue should be litigated in a plenary suit by reason of a possible appearance of institutional bias in the Bankruptcy Court in favor of bankrupt estates (Seaboard Brief, pp. 40-41) should be summarily rejected in view of the fact that the Associated Trustee, whose bankrupt estate is also being administered by Bankruptcy Judge Babitt, is Seaboard's ally on the merits of the allocation issue (398a-401a).

consent by Seaboard to such jurisdiction, both express and implied.*

The principles governing summary jurisdiction by consent are succinctly summarized in 2 Collier, *Bankruptcy* ¶ 23.08 at 536 (14th ed. 1976):

Once consent to the summary jurisdiction of the bankruptcy court appears, that jurisdiction generally will be retained for the determination of all the claims of the parties and for the enforcement of all their rights against each other. Consent having been given, it may not subsequently be withdrawn by a party; nor may the party, upon appeal from the decision, raise the question of want of jurisdiction.

Consent, as hereafter demonstrated, may be (1) express; (b) by waiver through failure to raise the proper objection, or (3) implied from any act indicating a willingness on the part of the party that his claim or interest be determined summarily by the bankruptcy court.

In the present case, Seaboard has expressly as well as impliedly consented to have the allocation issue determined by the Bankruptcy Court.

Express Consent.—The record is clear that the instant action was the outgrowth of the Trustee's motion to hold Seaboard in contempt and to enjoin Seaboard from further interfering with the administration of the estate, particularly by sending letters to Eastern shippers urging

* Contrary to the suggestions made in Seaboard's Brief, pp. 30-31, the District Court did not "eliminate" Seaboard's consent as a proper basis for jurisdiction. Rather, in view of the fact that the Bankruptcy Court did not pass on these contentions and its holding that a separate independent basis existed, the District Court expressly declined to reach the consent issue. See 671a. The District Court did hold however that Seaboard's litigation of the set-off issue did not amount to a "consent" to summary jurisdiction over the allocation issue. 671a-672a.

them to exercise set-offs. See pp. 6-7, *supra*. In order to eliminate the contempt charges and to have a speedy determination of the rights of all of the parties, Seaboard and the other parties, with the aid of the Bankruptcy Court, agreed that an adversary proceeding in the Bankruptcy Court would be commenced in which Seaboard, the Eastern and Associated Trustees, Manufacturers and other claimants to the Eastern accounts receivable would be parties, which adversary proceeding would be dispositive of all of the rights of the parties thereto, *including* the issue of the allocation of the Chase letter of credit. See pp. 6-7, *supra*. The following excerpts from the transcripts of the hearings of October 14, October 21 and October 26, 1976 before the Bankruptcy Court make this clear:

October 14, 1976

(123a-124a)

Mr. Cheser [counsel to Seaboard]: I think it will help a great deal. You [Mr. Marcus, counsel to Eastern Trustee] will start your action and we will start to get a stipulation of facts as soon as we can. We are dealing with banks. If they have improperly gotten money, the Court can order them to disgorge it, if we got what we are not entitled to * * * the Court can order us to disgorge it.

(128a-129a)

Mr. Marcus: * * * I ask that now we sit and see if we can come back to your Honor with an agreed set of facts and a *modus operandi*.

The Court: And a lawsuit?

Mr. Marcus: Yes, Sir, we want this as early as I think Seaboard does.

Mr. Cheser: Yes we do.

Mr. Marcus: If we are able to come in with that and—I told Mr. Cheser we would withdraw the action for contempt.

The Court: Yes, Mr. Kruger [counsel to Manufacturers and International Harvester]?*

Mr. Kruger: We have our own separate independent cause of action, it seems to me, against Seaboard of having converted these receivables because they interfered with our security interest.

The Court: Sue them.

Mr. Kruger: *I assume if we are talking about having one joint submission of facts we can agree and I certainly hope this is an appropriate forum for us to assert our claim against Seaboard.*

Mr. Cheser: *I will agree to that. I would like to get it disposed of in one action.*

(131a-132a)

The Court: Then there is no reason why reasonable minds can't stipulate between them by way of agreement they will be bound by the final decision of this Court in a suit entitled Gluck and Cahill against—why should we have a multiplicity of litigations.

Mr. Kruger: I am perfectly happy.

Mr. Cheser: *I agree.*

The Court: That's no problem.

(Emphasis supplied.)

October 21, 1976

(158a-159a)

The Court: Is it the contemplation of the secured parties to sue in this court?

Ms. Lee (counsel to Manufacturers and International Harvester): It is the contemplation of the secured parties to answer the complaint and press such counter-claims as they may have.

The Court: Let me just digress for a minute. You would be defendants in Mr. Gluck's suit or Mr. Cahill?

* The undersigned attorneys were subsequently substituted for Mr. Kruger's firm as counsel for Manufacturers in this proceeding.

Ms. Lee: We would be defendants as would Chase and the others.

The Court: Along with Seaboard?

Mr. Cheser: Yes.

The Court: You would then plead a counterclaim against Seaboard. Would there be jurisdiction in me?

* * *

The Court: *Will there be a consent to this jurisdiction by all parties?*

Mr. Cheser: *That was expressed last week.*

(Emphasis supplied.)

(163a)

[Mr. Cheser]: Regarding the letter of credit there are issues which may or may not come in the lawsuit that is being started. Until we see the final complaint, we cannot know. *There are issues as to whether the letter of credit was to cover only the obligations of Seaboard or of Seaboard and Associated together.*

There are a number of issues dealing with the letter of credit. The claim has been made by Ms. Lee that we look to the letter of credit first before we do anything with regard to offsets.

(Emphasis supplied.)

October 26, 1976

(222a-223a)

Ms. Lee: There is an additional part missing from your element, a two million dollar fund which if Mr. Cheser properly applied would properly protect him. It's two million dollars. He has the fund.

He handed us a paper on Thursday which shows he expended eighty-three thousand dollars of that fund to Eastern. He may have expended other sums for other purposes.

If the fund is an Eastern fund he has one million nine hundred thousand dollars to protect himself and

nobody else has a claim to that except Chase who may be entitled to the funds that Seaboard doesn't need.

Mr. Cheser: May I address myself to that?

The Court: Yes.

Mr. Cheser: *The question of whether that letter of credit covers only Eastern and not Associated is a contested question.* If Your Honor will look at Paragraph 13 of the application to punish us for contempt, it is stated by the trustee for Eastern that the letter of credit was meant to cover the obligations of both Eastern and Associated.

In addition, there is a cross-indemnity agreement between Eastern and Associated which makes each liable for the debts of the other. *However, that is only in passing with regard to the letter of credit which will be litigated before you on consent of the banks to your jurisdiction.*

The Court: They don't give me greater jurisdiction by consent than I would otherwise have.

Mr. Cheser: *We were under the impression last week you were prepared to take the complaint.*

(Emphasis supplied.)

(240a-241a)

Mr. Cheser: Your Honor, may I ask the trustee from Eastern and Associated when, if ever, they plan to serve a complaint that they serve the complaint that they have been asked to serve by Your Honor—and they have agreed to us they are preparing to serve.

We do have to get the basic issue determined. I would also like to ask the trustee from Eastern whether he is withdrawing that part of his application which is before Your Honor—

The Court: For contempt?

Mr. Cheser: We will deal with that.

The Court: I will deny that. I didn't understand Mr. Booth to press it.

(250a)

The Court: All right. Is there anything else I need? Thank you, Mr. Booth. Might I suggest that you and Mr. Cahill consider beginning your actions as soon as you can. Let's get the issues drawn. If there are no contested issues of fact, I will entertain cross-motions for summary judgment or a declaratory judgment and we will get this thing on the road.

Having so given its express consent to have the allocation issue determined in this adversary proceeding, Seaboard's subsequent attempt to object to jurisdiction comes with ill grace. In any event, Seaboard's attempt to now disclaim jurisdiction must fail, since the law is clear that consent to summary jurisdiction once given, may not be withdrawn. See, e.g., *In re Prokop*, 65 F.2d 628, 630 (7th Cir. 1933); *Operators' Piano Co. v. First Wisconsin Trust Co.*, 283 Fed. 904, 906 (7th Cir. 1922); *Honeyman v. Hughes*, 156 F.2d 27 (9th Cir.), *cert. denied*, 329 U.S. 739 (1946).

Consent By Filing Proof Of Claim As Secured Creditor.

--Seaboard has filed a proof of claim in the Eastern estate, sworn to on December 8, 1976, with respect to its alleged rights to be indemnified by Eastern for payments it has made and anticipates making under "various bonds executed by Seaboard on behalf of the Bankrupt herein [Eastern] and Associated * * *." Paragraph 11 of that proof of claim reads as follows:

11. No security interest is held for this claim except the attached Letter of Credit in the sum of \$2,000,000 which Seaboard contends is security for the payments made and to be made by it in connection with the discharge of its liabilities on various bonds executed on behalf of this Bankrupt and Associated.

By filing such a proof of claim, Seaboard has consented to the examination by the Bankruptcy Court into all circumstances connected with the validity of the claim and

the value and scope of the security claimed to be held by Seaboard. Thus, Bankruptcy Rule 306(d), which restates Section 57h of the Bankruptcy Act, provides as follows:

Secured Claims. If a secured creditor files a proof of claim, the value of the security interest held by him as collateral for his claim shall be determined by the court, and the claim shall be allowed only to the extent it is enforceable for any excess of the claim over such value.

See, e.g., *In re Quinn*, 165 Fed. 144, 145-46 (8th Cir. 1908); *In re Jackson Brick & Tile Co.*, 189 Fed. 636, 642-43 (D. Mo. 1911), *rev'd on other grounds*, 195 Fed. 188 (8th Cir. 1912). *Cf. Law Research Service, Inc. v. Crook*, 524 F.2d 301, 311, 313 (2d Cir. 1975).

Moreover, without regard to Seaboard's status as a secured creditor, jurisdiction in the Bankruptcy Court to examine into all aspects of Seaboard's claim and the alleged security therefor is clearly within the powers granted to the Bankruptcy Court under Section 2 of the Act. As set forth in the landmark case of *Pepper v. Litton*, 308 U.S. 295, 304-06 (1939):

Among the granted powers are the allowance and disallowance of claims; the collection and distribution of the estates of bankrupts and the determination of controversies in relation thereto; the rejection in whole or in part "according to the equities of the case" of claims previously allowed; and the entering of such judgments "as may be necessary for the enforcement of the provisions" of the act. In such respects the jurisdiction of the bankruptcy court is exclusive of all other courts. [Citation omitted.]

The bankruptcy courts have exercised these equitable powers in passing on a wide range of problems arising out of the administration of bankrupt estates. They have been invoked to the end that fraud will not pre-

vail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done. By reason of the express provisions of § 2 these equitable powers are to be exercised on the allowance of claims * * *

Hence, this Court has held that a bankruptcy court has full power to inquire into the validity of any claim asserted against the estate and to disallow it if it is ascertained to be without lawful existence. * * * It may ascertain the validity of liens, marshal them, and control their enforcement and liquidation. * * *

308 U.S. at 304-06.

Thus, the filing of Seaboard's proof of claim is yet another manifestation by Seaboard of consent to have the allocation issue determined by the Bankruptcy Court.

Consent By Seeking Affirmative Relief.—Quite apart from the fact that Seaboard has sought affirmative relief from the Bankruptcy Court upon its set-off claims, Seaboard has also sought affirmative relief with respect to the very allocation issue as to which it objects to summary jurisdiction. Thus, in the District Court, Seaboard sought a determination that the Eastern Trustee is estopped from asserting that the proceeds of the Chase letter of credit constitute security only for payments made by Seaboard on Eastern freight claims (676a).^{*} Seaboard's support for this contention was the underlying documentation of the transactions between Eastern, Seaboard and Associated (676a). See also Seaboard Brief, p. 21 fn.

^{*} Seaboard contends that with the Eastern Trustee eliminated, the dispute will be solely between third parties (*i.e.*, Seaboard, Manufacturers, Chase and the other secured parties) and beyond the jurisdiction of the Bankruptcy Court. However, since determination of the dispute will still be necessary before the estate can be completely administered, see pp. 38-40, *supra*, this contention is without merit. See cases cited at pp. 39-40, *supra*.

The District Court held that this argument was defective in that it assumed a favorable (to Seaboard) result of the evidentiary hearing to be held to determine the allocation issue itself (676a). Nonetheless, Seaboard persists in making this argument upon this appeal. Seaboard Brief, p. 21 fn.

The estoppel contention by Seaboard necessarily carries with it a claim on the merits of the allocation issue, to wit, that the estoppel sought precludes the Eastern Trustee from claiming that the letter of credit proceeds have not been exhausted.

A party that seeks affirmative relief from the Bankruptcy Court thereby consents to that Court's summary jurisdiction over the subject matter of the issue presented. *In re Engineers Oil Properties Corp.*, 72 F.Supp. 989, 990 (S.D.N.Y. 1947); 2 Collier, *Bankruptcy* ¶ 23.08 at 551 (14th ed. 1976). By seeking affirmative relief declaring that the Eastern Trustee is estopped from litigating the allocation issue, Seaboard has again manifested its consent to summary jurisdiction of the Bankruptcy Court to determine that issue.

* * * *

As shown above, the holdings below that the Bankruptcy Court had jurisdiction to determine how the proceeds of the Chase letter of credit should be applied was correct, not only upon the ground stated by the courts below, but upon other well-established grounds as well. Seaboard's jurisdictional objection was properly rejected.

CONCLUSION

The order appealed from must be affirmed in all respects.

Dated: New York, New York
February 28, 1978.

Respectfully submitted,
WACHTELL, LIPTON, ROSEN & KATZ
Attorneys for Defendant-Appellee
Manufacturers Hanover Trust Company

THEODORE GEWERTZ
RONALD M. NEUMANN
Of Counsel

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

In Re
EASTERN FREIGHT WAYS, INC.,

Bankrupt,

SIDNEY B. GLUCK, Trustee in Bankruptcy
of EASTERN FREIGHT WAYS, INC.,

Plaintiff-Appellee,

against

SEABOARD SURETY COMPANY,

Defendant-Appellant,
MANUFACTURERS HANOVER TRUST CO., et al.,
Defendants-Appellees.

State of New York,
County of New York,
City of New York—ss.:

DAVID F. WILSON being duly sworn, deposes
and says that he is over the age of 18 years. That on the 28th
day of February, 1978, he served two copies of the
Brief of Appellee Manufacturers Hanover Trust Co. on
see attached list

the attorneys for ~~the~~ see attached list
by depositing the same, properly enclosed in a securely sealed
post-paid wrapper, in a Branch Post Office regularly maintained
by the Government of the United States at 90 Church Street, Borough
of Manhattan, City of New York, directed to said attorneys at
No. see attached list () N. Y.,
that being the address designated by them for that purpose upon
the preceding papers in this action.

David F. Wilson
.....

Sworn to before me this

28th day of February, 1978.

Courtney J. Brown

COURTNEY J. BROWN
Notary Public, State of New York
No. 3472920
Qualified in New York County
Commission Expires March 30, 1980

Booth, Lipton & Lipton
405 Park Avenue
New York, New York 10022

Marcus & Angel
60 East 56th Street
New York, New York 10022

Co-counsel for Plaintiff-
Appellee Sidney B. Gluck

Milbank, Tweed, Hadley & McCloy
Attorneys for Defendant-Appellee
The Chase Manhattan Bank, N.A.
One Chase Manhattan Plaza
New York, New York 10005

Conboy, Hewitt, O'Brien & Boardman
Attorneys for Defendant-Appellee
Fruehauf Corporation
20 Exchange Place
New York, New York 10005

Anderson, Russell, Kill & Olick, P.C.
Attorneys for Defendant-Appellee
Thomas J. Cahill
630 Fifth Avenue
New York, New York 10020

Krause, Hirsch & Gross, Esqs.
Attorneys for Defendant-Appellee
International Harvester Credit
Corporation
41 East 42nd Street
New York, New York 10017

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

In Re
EASTERN FREIGHT WAYS, INC.,
Bankrupt,
SIDNEY B. GLUCK, Trustee in Bank-
ruptcy of EASTERN FREIGHT WAYS,
INC.,
Plaintiff-Appellee,
against
SEABOARD SURETY COMPANY,
Defendant-Appellant,
MANUFACTURERS HANOVER TRUST CO.
et al.,
Defendants-Appellees.

State of New York,
County of New York,
City of New York—ss.:

DAVID F. WILSON, being duly sworn, deposes
and says that he is over the age of 18 years. That on the 28th
day of February, 1978, he served two copies of
Brief of Appellee Manufacturers Hanover Trust Co. on
Wickes, Riddell, Bloomer, Jacobi & McGuire and on
Tell, Cheser, Breitbart & Lefkowitz, the attorneys
for Defendant-Appellant Seaboard Surety Company
by delivering to and leaving same with a proper person in charge of
their office at 59 Maiden Lane and 116 John Street,
respectively
in the Borough of Manhattan, City of New York, between
the usual business hours of said day.

David F. Wilson

Sworn to before me this

28th day of February, 1978.

Courtney J. Brown

COURTNEY J. BROWN
Notary Public, State of New York
No. 31-5472920
Qualified in New York County
Commission Expires March 30, 1979